LEGISLATIVE SERVICES AGENCY
OFFICE OF FISCAL AND MANAGEMENT ANALYSIS

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FISCAL IMPACT STATEMENT

LS 6493 **DATE PREPARED:** Jan 2, 2002
BILL NUMBER: HB 1003 **BILL AMENDED:**

SUBJECT: 21st Century Tax Plan.

FISCAL ANALYST: Diane Powers
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FUNDS AFFECTED: X GENERAL
X DEDICATED
FEDERAL

IMPACT: State & Local

Summary of Legislation: ***Corporate Taxes:*** This bill repeals the: (1) Gross Income Tax; (2) Supplemental Net Income Tax; (3) Bank Tax; (4) Savings and Loan Tax; and (5) Production Credit Association Tax. The bill establishes a Business Franchise Tax.

School General Fund Property Tax Levies: The bill reduces the maximum permissible school general fund property tax levy and increases the state funding of schools.

Welfare Property Tax Levies: The bill reduces part of the county general fund levy used to fund the county's obligation for: (1) the Hospital Care for the Indigent Program or Uninsured Parent Program (formerly the HCI Fund). The bill eliminates the property tax levy for the Family and Children's Fund, the County Medical Assistance to Wards Fund, and the County Children with Special Health Care Needs Fund and provides state funding to replace the eliminated part of each levy.

Trial Court Levies: The bill transfers to the state certain court fees and a part of the Excise Tax and Financial Institutions Tax revenue previously distributed to counties. The bill reduces the county general fund levies used to fund court personnel and operations. The bill transfers the funding of trial courts to the state.

Pension Relief: This bill provides for an additional distribution of $30,000,000 per year for pension relief.

Homestead Credit: The bill increases the Homestead Credit to 15%.

Earned Income Tax Credit: The bill expands the Earned Income Tax Credit.

Income Tax Deductions: The bill increases the Renter's Deduction and Dependent Child Deduction.

Research Expense Credit: The bill increases the Research Expense Credit to 20% and eliminates the

apportionment factor. The expiration date of this credit is eliminated.

Inventory Tax Credit: The bill establishes a Property Tax Replacement Credit for inventory.

Business Investment Tax Credit: This bill establishes a Business Investment Credit against state tax liability for property taxes paid on personal business property.

Adjusted Gross Income Tax: The bill increases the Adjusted Gross Income Tax rate.

Property Tax Replacement Credit: The bill eliminates the state 20% Property Tax Replacement Credit.

Sales & Use Tax: The bill increases the Sales and Use Tax to 6%.

New Funds: The bill also establishes the Tax Relief Fund and the Tuition Support Stabilization Fund.

Effective Date: July 1, 2002; January 1, 2003; July 1, 2003.

Explanation of State Expenditures: *Summary:* This bill contains several provisions that impact state expenditures and revenues. The net increase in estimated expenditures is $426.8 M in FY 2003 and $950.8 M in FY 2004. Estimated net revenue increases total $945.4 M in FY 2003, and $1,255.0 M in FY 2004. The net impact of the revenue increases over estimated expenditure is approximately $518.6 M in FY 2003 and $304.2 M in FY 2004. The fiscal impact of each provision is summarized in the table below.

Net Expenditure and Revenue Impacts		
Provision	**FY 2003**	**FY 2004**
State Expenditures:		
Net School Levy Reductions *	$448.3 M	$908.6 M #
Net Welfare Levy Reductions *	153.2 M	314.0 M
Net Trial Court Levies/Fees *	69.2 M	140.4 M #
Police & Fire Pension Levy Relief	15.0 M	30.0 M
Homestead Credit- Increase to 15%	22.5 M	124.7 M
Inventory Tax Replacement Credit	201.1 M	411.0 M
Elimination of PTRC	(482.5 M)	(977.9 M)
Total Change in Expenditures	$426.8 M	$950.8 M
State Revenues:		
Elimination of Corporate Gross Income Tax	($162.8 M)	($340.4 M)
Elimination of SNIT/Increase Corp AGI	37.9 M	80.0 M
Business Franchise Tax	189.2 M	321.0 M
Research Expense Credit	(34.3 M)	(71.3 M)
Individual AGI - Graduated Rate	224.4 M	602.2 M
Increase Child Exemption- Add. $500	(14.4 M)	(34.8 M)
Increase Renter's Deduction- Add. $1,000		(27.0 M)
Increase Earned Income Tax Credit	(15.0 M)	(36.0 M)
Investment Tax Credit		(45.1 M)
Increase Sales Tax - Add 1%	720.4 M	806.4 M
Total Change in Revenues	$945.4 M	$1,255.0 M
Balance to be distributed to Reserve Funds	$518.6 M	$304.2 M

* Expenditure estimates are net of the state capturing Excise Taxes, FIT, and court fees.

FY 2004 expenditure growth rates reflect the current revenue forecast and not the historical increases in these expenditures. Growth rates could be higher depending on future appropriations.

School General Fund Property Tax Levies: This bill reduces school general fund property tax levies for CY 2003 by $896.5 M and the amount of Motor Vehicle Excise Tax and Financial Institutions Tax (FIT) that is distributed to schools by $110 M. The CY 2003 state school formula spending limit is increased to offset the reduction in the levies and Motor Vehicle Excise Taxes and FIT. The state captures the reduction in Motor Vehicle Excise Tax and FIT due to reductions in the levies as state General Fund revenue. The net impact of the provision is the decrease in the school general fund levies. The bill does not increase the FY 2003 appropriation for tuition support. Without an increase in the appropriation, the state tuition support distribution for FY 2003 would have to be reduced by $503.4 M to keep the distribution within the current appropriation. The estimated increase in state funding needed for FY 2003 is $448.25 M (½ of the CY 2003 amount of $896.5M). Currently no school formula exists for CY 2004. Assuming that the CY 2004 formula would continue the CY 2003 trend of providing about 80% state funding, the increase in tuition support responsibility for FY 2004 would be $908.6 M (½ of the CY 2003 amount of $896.5 M and ½ of the CY 2004 amount of $920.7 M).

School Funding Calendar Year Projections		2002	2003	2004
State Support	Bill	$3,471,100,000	$ 4,600,900,000	$4,725,800,000
	Current	3,471,100,000	3,594,200,000	3,691,900,000
	Difference		1,006,700,000	1,033,900,000
Property Taxes	Bill	1,717,900,000	881,700,000	905,600,000
	Current	1,717,900,000	1,778,200,000	1,826,300,000
	Difference		(896,500,000)	(920,700,000)
Motor Vehicle Excise & FIT	Bill	215,300,000	110,200,000	112,500,000
	Current	215,300,000	220,400,000	225,700,000
	Difference		(110,200,000)	(113,200,000)
Total	Bill	5,404,300,000	5,592,800,000	5,787,900,000
	Current	5,404,300,000	5,592,800,000	5,787,900,000
	Difference		0	0

Welfare Levy Elimination: This bill eliminates the remaining county funding of welfare and children's services and transfers funding responsibility to the state. (HEA 1001-1999 removed the property tax levies for the County Welfare Fund and the County Welfare Administration Fund.)

Beginning in CY 2003, the state would be responsible for the current county expenditures for welfare and children's services. The projections below are based on estimated growth in child welfare expenditures of about 5% per year reflecting the average annual increase from 1998 to 2001.

The state already contributes to this expenditure in the form of Property Tax Replacement Credit (PTRC) and Homestead Credit. Part of the counties' funding also comes from distributions of Excise Taxes (Motor Vehicle, Commercial Vehicle, Boat, and Aircraft) and Financial Institutions Tax (FIT) revenue. The state will receive Excise Taxes and FIT payments attributable to the welfare funds from counties under this provision. The additional state expenditure estimates for the state takeover of the gross welfare levies are presented by fund in the following table.

Estimated Cost for State Takeover of Gross Welfare Levies (In $ Millions)						
Fund	**CY 2003**	**CY 2004**	**CY 2005**	**FY 2003**	**FY 2004**	**FY 2005**
Family & Children	$236.1	$247.9	$260.3	$118.0	$241.9	$254.0
HCI	52.3	55.0	57.8	26.2	53.7	56.4
MAW	11.2	11.8	12.4	5.6	11.5	12.1
Children w/ Health Needs	6.8	7.0	7.3	3.4	6.9	7.2
TOTAL	**$306.4**	**$321.7**	**$337.8**	**$153.2**	**$314.0**	**$329.7**

Trial Court Levies: The following court expenditures would be assumed by the state:

- salaries of other judicial officers (court commissioners and referees), court reporters, bailiffs, jury commissioners, court administrators and staff, secretaries, law clerks, court clerks and other employees, probation office;
- per diem costs for reporters and bailiffs for cases venued in and out;
- per diem fees for grand jurors;
- per diem fees for petit jurors;
- witness fees;
- fees for witnesses providing medical and psychiatric testimony;
- judges' pro tem payments;
- other nonsalary expenses, supplies, rentals, lodging and meals for jurors;
- other services and charges; and
- other capital outlays.

The following fees and related interest on investments that are currently deposited into the county general fund would now be deposited in the state General Fund:

- court costs fees,
- adult probation user fees,
- juvenile probation user fees,
- jury fees, and
- other fees.

The projected net expenses to the state are based on a five-year history of revenues and expenditures projected through FY 2005. Expenditures include the items associated with the daily operations of the courts, the additional costs for fringe benefits and health insurance for full-time court employees, and the fringe benefits for part-time court employees.

Part of current funding comes from county distributions of Excise Taxes (Motor Vehicle, Commercial Vehicle, Boat, and Aircraft) and Financial Institutions Tax (FIT) revenue. The state will receive Excise Taxes and FIT payments attributable to levies for court expenditures under this provision.

Net Trial Court Expenditures Assumed by the State	**FY 2003**	**FY 2004**	**FY 2005**
	$69.2 M	$140.4 M	$144.2 M

Pension Relief Distribution: This bill appropriates $30 M annually from the state General Fund to units that receive distributions from the Pension Relief Fund. This is in addition to the regular distributions made to the Pension Relief Fund. The distributions required shall be made in two equal installments before July 1 and October 2 of each year. The amount to be distributed to each unit of local government shall be determined by the Public Employees' Retirement Fund Board. This provision is effective January 1, 2003, so $15 M will be distributed in FY 2003 and $30 M in FY 2004.

In addition, the Department of Local Government Finance (State Tax Board) is required to reduce each unit's property tax levy by an amount equal to the distribution.

Homestead Credit Increase: Currently, Homestead Credits are equal to 10% of homeowners' property tax liability. The Homestead Credit percentage is scheduled to change to 4% in CY 2004. This provision would permanently set the Homestead Credit at 15% beginning in CY 2003. In CY 2001, Homestead Credits (at

10%) amounted to $195.5 M.

In addition to the increase in the Homestead Credit rate, the property tax levy reductions found elsewhere in this bill will also have an impact in the cost of providing Homestead Credits. The following table summarizes all of the changes in this bill that affect the cost of the Homestead Credit. The changes made by the levy reductions were considered first. The resulting Homestead Credit cost serves as the base for the change in the credit percentage.

Summary of Homestead Credit Cost Increase					
Cal. Year	**Current %**	**New %**	**Cost Change From Levy Reduction**	**Cost Change From Percentage Change**	**Total Cost Change**
2003	10%	15%	$ (52.4 M)	$ 97.4 M	$ 45.0 M
2004	4%	15%	(22.1 M)	226.5 M	204.4 M
2005	4%	15%	(23.4 M)	239.5 M	216.1 M

The following table is a summary of the total Homestead Credit cost changes by state fiscal year.

Summary of Homestead Credit Cost Increase	
Fiscal Year	**Total Cost Increase**
2003	$ 22.5 M
2004	124.7 M
2005	210.3 M

Inventory Tax Replacement Credit: Under this provision, the state would provide a 100% credit for property taxes due on inventory assessments. The credit would be passed through county auditors and paid to civil taxing units and schools at the same time that property taxes are distributed.

Estimation Issues: In estimating the impact of this provision, special attention was given to the impending real property reassessment. The final rules on real property assessment and personal property assessment will have a direct impact on property tax rates and the amount of the property tax levy that will be attributed to inventory. The real property reassessment will shift some of the property tax burden from personal property owners to real property owners, while the new personal property assessment rule will moderate that shift to some extent. The total increase in assessed value for 2002 pay 2003 is estimated at about 61.1%, taking both the new real property and personal property rules into account. It was assumed that the next reassessment will apply to property assessed in 2002 with taxes first paid in 2003 as mandated in the latest order from the Indiana Tax Court.

While it is difficult or impossible to estimate, the complete removal of the tax burden on inventory will provide an incentive for taxpayers to report more inventory in the state. Taxpayers who currently move inventory out of state may keep more of their inventory in Indiana. Also, the elimination of property tax on inventory may attract new operations that hold inventories. The estimated cost of the Inventory Tax Replacement Credit presented below is based on historical growths and known factors. If, in fact, this provision causes behavioral changes that result in higher levels of inventory, the actual cost of the credit will exceed the estimates below.

Data: According to the State Tax Board's Property Tax Analysis for various years, the net property tax on inventory equaled $406.9 M in CY 2000 and $427.6 M in CY 2001. The 2000 pay 2001 inventory AV was $4.70 B and has grown at an average annual rate of 2.7% over the last five years. The statewide net average property tax rate was $8.6955 per $100 AV in CY 2000 and $8.8151 per $100 AV in CY 2001.

Fiscal Impact: Future inventory assessed values were projected based on historical data. Future average net property tax rates were estimated based on historical data, the levy reductions for welfare funds, school general funds, county court appropriations found elsewhere in this bill, and on the estimated changes to the total tax base due to the newly adopted real property and personal property assessment regulations. Based on estimates of future total tax levies and total assessed values, it is estimated that the statewide average net tax rate will grow at a rate of about 1.4% per year in non-reassessment years. An estimate of the future net property tax on inventory was computed by multiplying the estimated net assessed value of inventory by the estimated net average tax rates.

The table below shows the estimated net cost to the state to provide the 100% inventory credit beginning in CY 2003.

Estimated State Cost of Inventory Tax Credit			
Calendar Year	**Credit Amount**	**Fiscal Year**	**Credit Amount**
CY 2003	$ 402.2 M	FY 2003	$ 201.1 M
CY 2004	419.8 M	FY 2004	411.0 M
CY 2005	438.2 M	FY 2005	429.0 M

Based on the estimated growth rates of inventory assessed value and net property tax rates, the cost of the credit is estimated to grow at about 4% to 5% per year.

Under current law, the state will allow a credit against state income tax for the property tax paid on the first $37,500 AV of a taxpayer's business personal property in the state. The $37,500 AV credit will be first available based on property tax paid in CY 2003 and can be claimed beginning in 2004 when taxpayers file their 2003 income tax returns. In some cases, the elimination of a taxpayer's net property tax on inventory contained in this bill could reduce the state's liability for the business personal property income tax credit. While there is no mechanism to segregate inventory from depreciable property as they apply to the $37,500 AV credit, there are some taxpayers who have total assessments, including inventory, that are at or under $37,500. For these taxpayers it is clear that the Inventory Tax reduction in this bill would reduce the state's income tax credit liability. The amount of the reduced state liability for the income tax credit is estimated at $3 M - $6 M annually under this bill and would affect revenue collections beginning in FY 2004.

Property Tax Replacement Credit Elimination: Under current law, the state pays Property Tax Replacement Credits (PTRC) in the amount of 20% of most school and civil taxing unit operating fund levies. PTRC is currently paid from the Property Tax Replacement Fund which is annually supplemented by the state General Fund.

The state's PTRC expense would be eliminated under this bill beginning in CY 2003. The PTRC expense was $886.5M in CY 2001 and has grown at an average annual rate of 4.3% over the last five years. The reduction in PTRC expenditures under this bill is estimated in the following table.

Estimated State PTRC Expenditure Reductions			
Calendar Year	**Credit Amount**	**Fiscal Year**	**Credit Amount**
CY 2003	$ 964.9 M	FY 2003	$ 482.5 M
CY 2004	991.0 M	FY 2004	977.9 M
CY 2005	1,017.7 M	FY 2005	1,004.4 M

The bill would abolish the Property Tax Replacement Fund (PTRF). Under current law, 40% of Sales Tax collections are placed into the PTRF. This bill would redirect that portion of the collections to the state General Fund.

Currently, if the Rainy Day Fund (RDF) balance at the end of a state fiscal year exceeds 7% of the total state General Fund revenues for that year, the excess is appropriated from the RDF to the PTRF. Along with abolishing the PTRF, this bill would repeal the transfer requirement. After FY 2003 the RDF balance would not be subject to any cap and would continue to grow based on interest earnings and statutory transfers to and from the General Fund.

Earned Income Tax Credit Refunds: The refundable portion of the earned income tax credit (EITC) qualifies as Maintenance of Effort (MOE) expenditures and would contribute toward the state's annual MOE requirement under the Temporary Assistance to Needy Families (TANF) program. Based on data from 1999 tax returns, EITC refunds for those eligible under current law total an estimated $13.8 M. The changes proposed in the bill are estimated to increase the refundable EITC by about $25.4 M annually.

<u>Explanation of State Revenues:</u>

Corporate Taxes: This bill eliminates the Gross Income Tax and the Supplemental Net Income Tax and establishes a Corporate Adjusted Gross Income Tax at a rate of 8.5% applied to apportioned Indiana AGI.

This bill eliminates the Indiana Corporate Gross Income Tax, IC 6-2.1, as of December 31, 2002. Taxpayers filing on a calendar year basis will end their year and pay the final payment on April 15, 2003. Fiscal year Corporate Gross Income Tax filers will also end their year on December 31, 2002, and make a payment for the shortened tax year on April 15, 2003. They may then begin a new shortened year in 2003 to re-establish their fiscal year for tax purposes.

Background: Currently the Corporate Gross Income Tax applies to regular corporations who must compute their gross tax liability and their adjusted gross tax liability and pay the greater of the two. A corporation must then subtract that liability from apportioned Indiana Adjusted Gross Income (AGI) and pay Supplemental Net Income Tax (SNIT) at a rate of 4.5% on that tax base. The effective tax rate for a taxpayer paying Adjusted Gross Income Tax and Supplemental Net Income Tax is 7.747%.

Methodology: The impact of eliminating the Gross Income Tax is estimated by calculating Indiana Corporate AGI from Supplemental Net Income Tax payments. By applying the effective rate of 7.747% to the tax base and subtracting total corporate tax receipts for a given year, the effect of the Gross Income Tax on Indiana's corporate income tax revenue is isolated. The estimate of revenue lost in FY 2003, one-half the annual total for that year, is $162.75 M and $340.4 M in FY 2004.

Increasing the tax rate from an effective rate of 7.747% to 8.5% on apportioned Indiana AGI is effective for taxable years beginning after December 31, 2002. Therefore, it would take effect mid-way through state FY 2003. If corporations adjusted tax payments immediately, the impact is estimated to be an additional $37.9 M in FY 2003. It is likely that taxpayers will not adjust on time and that most taxpayers will not remit the full amount for the higher rate until filing after the end of their fiscal year. In that case most or all of the $37.9 M will be shifted into FY 2004. Adjusted Gross Income Tax revenue collections would increase by an additional $80 M in FY 2004.

Impact on Insurance Premiums Tax: This bill requires insurance firms based in Indiana (domestic insurers) to pay the Premium Tax on the insurance sales in Indiana, less allowable deductions. Under current law, domestic insurers may elect to pay either the Gross Income Tax or the Premium Tax. Domestic insurers are also required to pay SNIT regardless of their election of Gross Income Tax or Premium Tax. This bill, as noted above, will eliminate this SNIT liability. While data limitations make the specific tradeoff from these provisions on state General Fund revenues indeterminable, according to several industry sources, it is expected that the combination of these provisions will have an offsetting impact on state General Fund revenue during FY 2003 and FY 2004.

Background Information: The five-year phase down of the state's Premium Tax was initiated by P.L.144-2000 and lowered the rate from 2.0% in CY 2000 to 1.3% in CY 2005. The schedule is shown below.

Premium Tax Rate	
CY 2000	2.0%
CY 2001	1.9%
CY 2002	1.8%
CY 2003	1.7%
CY 2004	1.5%
CY 2005 and thereafter	1.3%

Of the approximately 100 domestic insurance firms that reported insurance sales in Indiana during CY 2000, 36 elected to pay the Premium Tax. These firms remitted approximately $3.1 M in Premium Taxes during CY 2000. Domestic insurers wrote approximately $2,643 M in taxable premiums in Indiana during CY 2000.

Business Franchise Tax: This bill also imposes a Business Franchise Tax measured by net worth on all legal entities doing business in Indiana. The term "legal entities" for tax purposes excludes sole proprietorships. The tax is imposed at a rate of 0.3% on net worth apportioned to Indiana. There is a minimum tax of $50 and a maximum tax of $100,000 per business entity. Members of a consolidated group for income tax purposes may not file for Franchise Tax on a consolidated basis. A taxpayer with ownership interest in another Indiana business may take a deduction equal to the amount of net worth invested in the other Indiana business, provided the taxpayer's ownership interest constitutes 20% of the total ownership of the business entity.

Methodology: The revenue from a Business Franchise Tax in Indiana was estimated based on the relationship between net worth and both employment [EMP] and gross state product [GSP]. Data from four states

(Alabama, Mississippi, North Carolina, and Tennessee) which currently have a franchise tax was utilized. A pooled, cross-sectional, time series ordinary least squares regression model describes the relationship between net worth and GSP and EMP. The model yielded an estimate of total net worth apportioned to Indiana which when multiplied by the 0.3% rate gave a projected revenue estimate for an uncapped franchise tax. An estimate of the effect of imposing a cap per entity on Indiana's Franchise Tax was constructed through analysis of Indiana business income tax return data. This methodology yields a forecast of $315.3 M for CY 2003, which is estimated to grow at the same rate as other business income, 3% per year.

Taxpayers are to remit this tax during the fourth month after their tax year begins. Approximately 60% of corporate tax payers file on a calendar year basis. Therefore, it is estimated that approximately $189.2 M will be remitted in FY 2003 and $321 M in FY 2004.

Research Expense Credit*:* This bill eliminates the apportionment factor for the Research Expense Credit and increases the credit from 5% to 20% for tax years beginning January 1, 2003. It is estimated that these changes will result in a revenue loss ranging from $22.5 M to $34.3 M in FY 2003 (due to changes in estimated quarterly payments) and $46.3 M to $71.3 M in FY 2004.

Over the past four years, the current Research Expense Credit has ranged from $9.2 M in FY 1996 to $24.2 M in FY 1999. It is difficult to estimate the exact impact of continuing this tax credit since it is dependent on both the amount of research expenses individual taxpayers make during the year and their total tax liability.

Apportionment Provision: This modification would mean that the credit is based on the taxpayer's Indiana qualified research expenses, rather than the lesser of its Indiana qualified research expenses or its apportioned research expenses for the tax year beginning January 1, 2003. Currently, only businesses that do not have income apportioned to the state for a taxable year may calculate their credit based on only Indiana research expenses.

This change would lower the tax liability for multi-state, Indiana-domiciled companies that conduct a significant proportion of their research in Indiana, compared to the research conducted through their non-Indiana operations. Elimination of the apportionment factor will allow all companies to compute their tax credit based on the amount of research actually conducted in the state. It is unknown how many Indiana businesses would be affected by this change.

Rate Change: The bill also increases the percentage of credit which may be taken for research and development activities from 5% to 20%.

Elimination of Expiration Date: This bill also eliminates the December 31, 2002, expiration date for this credit and effectively makes this a permanent credit available to taxpayers.

With additional incentives created for research and development activity based in the state of Indiana, the revenue loss from this credit could increase by an indeterminable amount. The credit provides $200,000 for each $1 M in new research expenses. Increased expenditures on research activities could also generate additional Adjusted Gross Income and Sales Tax revenue if these expenses are used to hire additional employees or purchase related equipment.

Research expense tax credit affects revenue collections deposited in the General Fund.

Graduated Individual AGI Tax Rate Structure: The bill replaces the current state AGI tax rate equal to 3.4% on all taxable income with a graduated tax rate structure beginning in tax year 2003. The graduated tax rate structure would impose a 3.9% rate on taxable income up to $90,000 and a 4.4% rate on taxable income above $90,000. The rate change alone is estimated to increase individual Adjusted Gross Income Tax revenue by 15.1%. The estimated increase is the average change in tax liability observed in simulations conducted with data from individual income tax records from 1996 to1999. As a result, the graduated tax rate structure is expected to increase revenue by approximately $224.4 M in FY 2003 and $602.2 M in FY 2004. These totals are based on the updated FY 2003 individual Adjusted Gross Income Tax forecast of $3,857.0 M and estimated FY 2004 revenue totaling $3,988.1 M. The FY 2004 estimate assumes 3.4% revenue growth over FY 2003 (equal to the forecast revenue growth for FY 2003). The FY 2003 total also assumes that the tax rate change will impact monthly withholding and quarterly estimated tax payments during the second half of the fiscal year. Some employers and tax payers may not make these adjustments on time to accurately reflect the tax change beginning January 1, 2003.

Increase in Dependent Child Exemption: The bill increases the exemption for dependent children from $1,500 to $2,000 per dependent child claimed beginning in tax year 2003. Under current law, a taxpayer may reduce his or her state taxable income by $1,500 per dependent child. For a taxpayer to claim the exemption, the dependent child must be (1) the taxpayer's son, stepson, daughter, stepdaughter, or foster child, and (2) either be under the age of 19 or a full-time student who is under the age of 24. In 1999, exemptions totaling $2,358.6 M were claimed for an estimated 1.57 M dependent children. The number of children claimed under the dependent child exemption is expected to increase to approximately 1.71 M in 2003 and 1.74 M in 2004. This estimate is based on recent trends in the federal dependent exemption which suggests a long-run increase of roughly 2% annually in the number of dependent children claimed. (Since the dependent child exemption was initiated in 1997, the growth rates between 1997 and 1999 are not indicative of the long-run trend that may be expected relative to this exemption.) Based on the dependent child estimates, the $500 increase in the exemption is expected to cost approximately $14.4 M in FY 2003 and $34.8 M in FY 2004. This assumes an average tax rate of 4.04%, which was derived from simulations of the tax rate change. The FY 2003 total also assumes that the change to the dependent child exemption will impact monthly withholding during the second half of the FY 2003.

Increase in Renter's Deduction: The bill increases the renter's deduction from $2,000 to $3,000 beginning in tax year 2003. Under current law, a taxpayer may deduct from his or her state taxable income an amount equal to the total rent paid during a tax year up to $2,000. The rent deducted must be paid on the taxpayer's principal place of residence. In 1999, 637,500 taxpayers deducted rent totaling approximately $1,187.9 M under the renter's deduction. From 1989 to 1998 the number of taxpayers claiming the deduction increased by about 1.33% annually, and the average amount deducted increased by about 0.57% per year. Based on these trends, the current $2,000 renter's deduction is estimated to total approximately $1,281.1 M in 2003 and $1,305.5 M in 2004. In addition, the 33% increase in the maximum allowable deduction in 1999 (from $1,500 to $2,000) resulted in a 28.5% increase in the average renter's deduction in 1999. This suggests that a 50% increase in the maximum allowable deduction (from $2,000 to $3,000) would result in a 42.7% increase in the average renter's deduction. Assuming the average of the two response rates (36%), the increase in the renter's deduction is estimated to cost approximately $27.0 M in FY 2004. This estimate also assumes an average tax rate of 4.04% which was derived in simulations of the tax rate change.

(Note: For taxpayers claiming both the dependent child exemption and the renter's deduction, the two provisions could interact such that the full extent of each increase is not claimed by such a taxpayer. This would require that the combined tax value of each increase exceeds the taxpayer's income tax liability. As a result, the interaction of the two provisions could serve to lower the estimated revenue loss from each.

However, the extent of this impact is not expected to be significant.)

Expansion of Earned Income Tax Credit: The bill increases the earned income tax credit (EITC) and expands the coverage of the credit beginning in tax year 2003. Under current law, a taxpayer may claim the EITC if: (1) the taxpayer has at least one qualifying child; (2) the taxpayer's income from all sources does not exceed \$12,000; and (3) at least 80% of the taxpayer's Indiana total income is earned income. The amount of this refundable credit is equal to:

(\$12,000 - the taxpayer's Indiana total income) x (the AGI tax rate of 3.4%).

The bill changes the maximum income level for purposes of computing the EITC from \$12,000 to \$18,000, and, in tandem with the AGI tax rate changes discussed above, the bill increases the rate at which the EITC is computed to 3.9%. Both of these changes will increase the credit amount made available to current EITC recipients. In addition, the increase in the income level will extend the credit to taxpayers whose income from all sources is between \$12,000 and \$18,000.

Data from 1999 income tax records indicates that approximately 105,000 taxpayers were eligible to claim the EITC under current law. The credit amount available to these taxpayers is estimated to total \$17.5 M, with refunds totaling an estimated \$13.8 M. The changes made by the bill are estimated to increase the annual cost of the EITC by approximately \$36.0 M. (Based on adjustments to withholdings, the estimated additional revenue loss in FY 2003 would be approximately \$15 M.) This estimate is based on simulations using data from 1999 tax return information for taxpayers with an Indiana total income between \$1 and \$18,000 and a qualifying child. The simulations account for the proposed AGI tax rate change and the proposed changes in the dependent child exemption and the renter's deduction.

Investment Tax Credit for New Personal Property: This provision creates an income tax credit available for owners of new business personal property. The property would have to be a newly purchased depreciable asset, be used in the production of income, and have a useful life of at least three years. The income tax credit would equal 25% of the net property tax paid on the property in its first taxable year and 15% of the net property tax paid on the property in its second taxable year.

The income tax credit may be taken against the taxpayer's liability under the Corporate Adjusted Gross Income Tax, Financial Institutions Tax, and Insurance Premiums Tax. If the amount of the credit exceeds the taxpayer's liability, the taxpayer would be entitled to a refund. The Investment Tax Credit would reduce state revenues.

The credit would be available for property first reported for the 2003 assessment date or in a later year. Property taxes for the 2003 assessment date would be paid in 2004. The credit would first be claimed for tax years beginning 2004. Adjusting for estimated quarterly payments, revenue collections would be impacted beginning in FY 2004 with the full cost of the credit beginning in FY 2005. The cost of the credit is estimated in the following table.

Investment Tax Credit State Revenue Reduction Estimate			
Tax Year	**Credit Amount**	**Fiscal Year**	**Credit Amount**
2004	$ 90.3 M	FY 2004	$ 45.1 M
2005	96.0 M	FY 2005	93.1 M

The Investment Tax Credit would not be available for property on which the taxpayer received a Capital Investment Tax Credit (in Shelby County) or a Rerefined Lubrication Oil Facility Credit.

Sales & Use Tax: This bill increases the Sales and Use Tax from 5% to 6% effective July 1, 2002. The bill also makes changes in the manner in which Sales and Use Tax revenue is distributed. The bill changes the distribution of the revenue so that revenue generated as a result of the tax increase is deposited into the state General Fund. The bill also shifts Sales and Use Tax distributions that previously went into the Property Tax Replacement Fund to the state General Fund. The bill changes the distributions to the Public Mass Transportation Fund, the Commuter Rail Service Fund, and the Industrial Rail Service Fund so that the amounts distributed to these funds do not increase as a result of the Sales Tax rate increase.

The increase will generate approximately $720.4 M in FY 2003 and $806.4 M in FY 2004. This estimate assumes that the Sales Tax revenue will grow 2.6% over FY 2003. (This is the same rate forecast for FY 2002 by the Revenue Technical Committee on November 14, 2001.) The estimate for FY 2003 assumes increased Sales Tax revenue from only 11 of the 12 months in which the increase is in effect during FY 2003 because of the timing of remittance and posting of Sales Tax revenue.

Sales and Use Taxes are currently deposited in the state General Fund (59.03%), the Property Tax Replacement Fund (40%), the Public Mass Transportation Fund (0.76%), the Commuter Rail Service Fund (0.17%), and the Industrial Rail Service Fund (0.04%). This bill will change the distribution to the following: state General Fund (99.192%), Public Mass Transportation Fund (0.633%), Commuter Rail Service Fund (0.142%), and the Industrial Rail Service Fund (0.033%).

New Funds: The bill also establishes the Tax Relief Fund and the Tuition Support Stabilization Fund. The Tax Relief Fund is established to provide a source of money to maintain the inventory tax replacement and homestead distributions and to meet the state's obligations for welfare, trial courts, and police and firefighter pension relief when economic conditions result in lower General Fund revenue collections. The Tuition Support Stabilization Fund is to provide a source of funds to maintain state tuition support payments under similar conditions. These funds are to be administered by the state Treasurer. Interest that accrues to these funds will remain in the funds. Money in the funds at the end of the fiscal year do not revert to the General Fund. The Budget Director shall determine the unused 21st Century Tax Plan balance to be transferred into these funds. Fifty percent of the balance shall be transferred into each fund.

Based on the above estimates, it is anticipated that approximately $518.6 M could be transferred to these funds (or $259.3 M each) at the end of FY 2003. Approximately $304.2 M (or $152.1 M each) could be transferred at the end of FY 2004.

<u>**Explanation of Local Expenditures:**</u> ***Trial Court Levies:*** *Background Information*: Under this bill, the counties would still be responsible for financing some court expenditures. The following lists the

expenditures the counties would continue funding:

- county supplements for judicial salaries,
- guardian ad litem and court-appointed special advocates,
- criminal defense for indigent defendants,
- law books, and
- the costs of operating juvenile detention facilities.

Pension Relief Distribution: Local units with members in the 1925, 1937, 1953, and/or the 1977 Funds will receive the additional distributions.

<u>Explanation of Local Revenues:</u>

School General Fund Property Tax Levies: The reductions in property taxes and Motor Vehicle Excise Tax and FIT revenue are offset by increased state tuition support funding.

Welfare Levy Elimination: County revenues and expenditures would both be reduced by the amount listed under the State Expenditure section for state welfare takeover. Overall, the expenditure change and the revenue change result in no net changes to counties.

Trial Court Levies: Because the state would assume the costs of the trial court expenditures described in State Expenditures, this bill would reduce the authority of county governments to tax property for these portions of the operations of the courts. Overall, the expenditure change and the revenue change result in no net changes to counties.

Background Information- Counties would continue to retain the following fees:

- support fees,
- guardian ad litem fees,
- supplemental public defender fees,
- user fees,
- county drug free community fees, and
- various other fees.

Homestead Credit Increase: The increase in Homestead Credits would not affect local revenues. Homeowners' property tax bills would be reduced by the additional credits, but the state would reimburse local taxing units for the lost revenue.

Inventory Tax Credit: This provision would not affect local revenues. Inventory owners' property tax bills would be reduced by the amount of net property tax that they pay on business inventory, but the state would reimburse local taxing units for the lost revenue.

Property Tax Replacement Credit Elimination: Total local revenues would not be affected by this provision. Taxpayers would pay the entire (gross) levy under this proposal, rather than the net (of PTRC) levy under current law. Likewise, TIF districts would no longer be permitted to allow a PTRC-like credit in the district.

Effects on Tax Increment Financing: Tax increment financing (TIF) allocations are equal to the incremental assessed value in a TIF area multiplied by the surrounding taxing district's tax rate. As a consequence of eliminating the welfare, court, and one-half of the school general fund levies and tax rates, TIF proceeds would be reduced. If these tax rates had been eliminated in CY 2001, TIF districts, statewide, would have lost about $26.2 M. However, this bill permits the TIF district's governing body to impose a special assessment on the property in the TIF area in order to meet the district's obligations.

Effects on Local Option Income Tax Distributions: Under current law, counties that impose the County Option Income Tax (COIT) may provide a locally funded Homestead Credit up to an additional 8%. COIT revenue that is not used to fund the local Homestead Credit is distributed to civil taxing units (counties, townships, cities, towns, libraries, and special taxing units). A reduction in the property tax levy would reduce the cost of providing the local Homestead Credit, thereby directing more COIT revenue to civil taxing units.

Under current law, counties that impose the County Adjusted Gross Income Tax (CAGIT) must allocate local Property Tax Replacement Credits to civil taxing units and to school corporations. The amount of property tax relief is dependent on the CAGIT tax rate and on the total amount of CAGIT proceeds in the county. The total amount of property tax levies does not affect the amount of CAGIT proceeds used for property tax relief. CAGIT revenue that is not used to reduce the property tax levies that are being eliminated under this bill would be used to reduce other property tax levies in the county.

COIT and CAGIT certified shares are the amount of local option tax proceeds that are available for distribution to civil taxing units after local Homestead Credits and local Property Tax Replacement Credits, respectively, are paid. Certified shares are distributed based on a civil taxing unit’s proportionate share of the total civil unit property tax levy. The bill adjusts the basis for the distribution to include the amount of the levies that are being eliminated. This calculation ensures that the bill does not alter the proportion of certified shares that civil units in adopting counties will receive.

Increases in Dependent Child Exemption & Renter’s Deduction: The bill increases the dependent child exemption and renter’s deduction beginning in tax year 2003. Because these changes will decrease Indiana taxable income, counties imposing local option income taxes (CAGIT, COIT, and/or CEDIT) may, as a result of the bill, experience an indeterminable decrease in revenue from these taxes.

State Agencies Affected: Auditor; Department of Education; Department of State Revenue; State Budget Agency; Public Employees’ Retirement Fund (PERF) as administrators of the Pension Relief Fund and the 1977 Police Officers’ and Firefighters’ Pension and Disability Fund; Department of Local Government Finance (State Tax Board); Indiana Supreme Court, Division of State Court Administration; Treasurer.

Local Agencies Affected: Local units with members in the 1925, 1937, 1953, and/or the 1977 Funds; Schools; Trial Courts; TIF districts; County auditors; all local taxing units that receive local option income tax revenue.

Information Sources: Revenue Technical Committee’s November 14, 2001, Revenue Forecast; Department of State Revenue; Property Tax Analysis, various years, Local Government Database- State Board of Tax Commissioners (Department of Local Government Finance); Doug Todd of McCready & Keane, Inc., actuaries for the Police and Fire Funds and PERF, 576-1508; School Finance Database; 1996 and 2000 Indiana Judicial Reports; Dan Bastin, Auditor of State’s Office.